

THE INCONSISTENT ADJUDICATION OF INDEPENDENT DIRECTORS’ LIABILITY AND ITS IMPACT ON THEIR ROLES AND RESPONSIBILITIES

*Divya Sethuraman & Priyanshi Kothari**

This paper aims to make a novel contribution to the literature on the roles and responsibilities of independent directors by examining the interpretive position adopted in case law dealing with the same. The paper discusses the Securities and Exchange Board of India (SEBI) and Securities Appellate Tribunal (SAT) decisions concerning the liability of independent directors as per §149(12) of the Companies Act, 2013, wherein their roles and responsibilities were discussed. Two trends in decision-making regarding the scope of an independent director’s duties have emerged. First, as exemplified in SEBI’s decision in MPS Infotech v. SEBI and the SAT decision in Svam Software v. SEBI, the ‘day-to-day functioning’ test is used to hold that since the independent directors did not perform day-to-day functioning, they could not be held liable. Second, as illustrated by the reasoning of SEBI’s decisions in Dish TV and Bombay Dyeing, the diligence standard of §149(12) is used to hold the independent director liable based on whether they independently reviewed the Board and the company’s activities. The piece infers that in the first trend, the independent director’s role is considered analogous to, and even the same as, that of other directors. Simultaneously, as per the 2013 Act and the second trend, daily participation in the company’s affairs, being non-executive directors in the 2013 Act, lies outside the independent director’s ambit. This divergent SEBI and SAT jurisprudence concerning §149(12) further muddles the unclear landscape of the roles and responsibilities of independent directors vis-à-vis other directors.

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* The authors are fourth year law-students at the National Law School of India University, Bengaluru. The authors would like to thank the Editors at the NUJS Law Review for their comments on earlier drafts of this paper. All errors, if any, are solely attributable to the authors. The authors may be reached at divya.sethuraman@nls.ac.in and priyanshi.kothari@nls.ac.in for any feedback or comments.

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I. INTRODUCTION

In the anatomy of the corporation, as investor ownership is separated from management, the shareholders possess ultimate control of the company.¹ The management of the affairs of the company is delegated to the Board of Directors (‘Board’).² This structure is adopted because it is generally accepted that since shareholders may be unable to coordinate easily and access relevant information continuously, delegation of management to the Board is necessary.³

The institution of the independent director within the Board of a publicly listed company originated in the United States of America (‘USA’) in the 1950s,⁴ and was soon codified.⁵ In the United Kingdom (‘UK’) too, independent directorship was formalised in 1992 by the Cadbury Committee Report.⁶ In the Indian context, the importance of constituting this institution was recognised amidst a slew of legislative reforms undertaken in the aftermath of the country’s economic liberalisation, and serious transgressions in corporate governance.⁷ In 2000, the Securities and Exchange Board of India (SEBI) introduced Clause 49 in the Equity Listing Agreement for publicly listed companies (‘Clause 49’), which contained provisions related to the independent director.⁸ The aim behind the incorporation of the position of the independent director was to maintain checks and balances and to enable independent review of the Board’s activities.⁹

Initially, the role of the independent director was not clearly identified, even in Clause 49. This changed with the introduction of the Companies Act, 2013 (‘Act’). §2(47), read with §149(6) of the Act, defines the independent director as one who occupies a position on the Board but who is otherwise not related to the company financially and filially, either as a part of the company’s daily affairs or its management.¹⁰ Independent directors are considered to belong to the class of non-executive directors as per the Act. They are required to be on the Board of all publicly listed companies,¹¹ and for a specific category of unlisted companies.¹² Their appointment and the scope of their role and responsibilities are detailed in the 2013 Act, the accompanying rules (for instance, the Companies Appointment and Qualification of

¹ Reinier Kraakman et al., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH*, 13 (Oxford University Press, 3rd edn., 2017) (‘Kraakman’).

² *Id.*, 11, 12.

³ *Id.*

⁴ Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, Vol. 6(2), *HASTINGS BUSINESS L. J.*, 294 (2010) (‘Varottil’).

⁵ *Id.*, 295.

⁶ *Id.*, 305.

⁷ *Id.*, 309, 310.

⁸ Securities and Exchange Board of India Listing Agreement, 2000, Clause 49.

⁹ VIDHI CENTRE FOR LEGAL POLICY, *The Liability Regime for Non-Executive and Independent Directors in India: A Case for Reform*, 27 (September 2019), available at <https://vidhilegalpolicy.in/research/the-liability-regime-for-non-executive-and-independent-directors-in-india-a-case-for-reform/#:~:text=A%20report%20published%20by%20the,independent%20directors%20and%20presents%20inf> ormed (Last visited on March 5, 2024) (‘Vidhi’).

¹⁰ The Companies Act, 2013, §§2(47), 149(6).

¹¹ *Id.*, §149(4).

¹² The Companies (Appointment and Qualification of Directors) Rules, 2014, R. 4.

Directors Rules, 2014),¹³ and for publicly listed companies, in SEBI's 2015 Listing Obligations and Disclosure Requirement Regulations ('LODR').¹⁴ This paper's focus is restricted to independent directors in the context of public companies in the Indian context. The role of independent directors and the interests they represent is identified in the law- they act in the interests of a variety of stakeholders, including minority shareholders and regulators. However, the nature of the interaction between the independent director's duties with the broader responsibilities of other directors on the Board remains unclear under the 2013 Act. While existing literature highlights the lack of legislative clarity on the roles and responsibilities of independent directors, especially when compared to other directors on the Board,¹⁵ it does not delineate the interpretive position adopted by courts and tribunals in case laws dealing with this subject matter. This paper is an attempt to fill this gap in the literature by analysing the trends in adjudicative authorities' interpretation of the role of the independent director in corporate governance, especially vis-à-vis other directors' roles.

This paper argues that in the adjudicative context, the jurisprudence on independent directors' roles and responsibilities in assessing their liability muddles this unclear landscape further. The same is exemplified by the decisions of SEBI and the Securities Appellate Tribunal (SAT) in their quasi-judicial capacity concerning §149(12), which describes situations where liability may be affixed on the independent director or non-executive director. This consideration often includes the roles and responsibilities of independent directors.

To elaborate, there are two kinds of decisions rendered by SEBI and the SAT. On the one hand, the role of the independent director is considered to be analogous to that of the other directors. This necessitates a check on their involvement in the day-to-day management of the company ('day-to-day functioning test'), in the absence of which they are not held liable. The adjudicative authority's discussion stops with the analysis that the knowledge gained by the independent director while participating in the Board process was insufficient to raise any suspicion. The test of diligence, or consent or connivance on the independent director's part, as per the text of §149(12), is ignored. On the other hand, certain decisions do recognise the independent director's particular role (vis-à-vis other directors) of maintaining checks and balances, independently reviewing Board activities, and accounting for the diligence requirement as per §149(12). This paper advocates for and supports the latter and provides reasons for the same.

Section II of the paper outlines the evolution of the independent director in corporate governance in the USA and the UK and its subsequent adoption in India. Next, it situates the independent director's role within the agency costs framework. In Section III, the paper highlights concerns regarding the role of the independent director in India, especially when directors as a class under the 2013 Act are required to undertake an expansive role, including accounting for the needs of various stakeholders. It then outlines the interpretive contours of §149(12). Subsequently, in Section IV, the paper identifies the trends in case law interpreting §149(12). Section V highlights the implications and detrimental consequences of those decisions that apply the test of day-to-day functioning, ignoring the diligence requirement necessitated by §149(12). Lastly, Section VI concludes this discussion.

¹³ *Id.*

¹⁴ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirement) Regulations, 2015.

¹⁵ Vikramaditya Khanna & Umakanth Varottil, *Board Independence in India: From Form to Function?* in INDEPENDENT DIRECTORS IN ASIA: A HISTORICAL, CONTEXTUAL AND COMPARATIVE APPROACH (Dan W. Puchniak et al. eds., Cambridge University Press, 2016); Deva Prasad M. et al., *Legislative Design of Director's Responsibility in India: In Search of Clarity*, Vol. 20(20), STATUTE L. REV., 1 (2020) ('Prasad').

II. THE EVOLUTION OF THE INDEPENDENT DIRECTOR IN CORPORATE GOVERNANCE

Before a discussion on the evolution of the independent director regime in the USA, UK, and India, it is imperative to delineate the differences in the shareholding patterns of publicly listed companies in the three jurisdictions.

A. NATURE OF SHAREHOLDING IN THE USA, THE UK, AND INDIA AND THEIR RESPECTIVE 'AGENCY' PROBLEMS

As per the classification proposed by Varottil, the shareholding pattern in the USA and UK is reminiscent of an 'outsider' model, while India represents the 'insider' model.¹⁶ To elaborate, in the USA and the UK, the distinction between ownership and management is exemplified, where shares in most corporations are diffusely owned by multiple investors, both individuals and institutions.¹⁷ These shareholders do not typically engage much in the management of the company's affairs. In this model, the managers and Board members exert considerable influence in managerial affairs.¹⁸ Although the shareholders elect the Board members, since the shareholder group itself is so diverse, no single group of investors unilaterally influences the Board's composition.¹⁹ The shareholders also do not participate in appointing managers who monitor the company's employees, nor do they necessarily sit on the Board. In fact, the managers (both Board members and otherwise) and shareholders often have conflicting interests regarding the company operations.²⁰

In contrast, in India, most corporations, including publicly listed ones, have identifiable groups of shareholders, i.e., the 'insiders.'²¹ With insiders forming the majority group of shareholders, the remaining shares are diffusely owned by a minority. In this setup, the fact that shareholders elect the Board members implies that the majority shareholders determine the constitution of the Board.²² Consequently, the majority shareholders and the Board have little conflict in their engagement.²³ Rather, it is the minority shareholders whose interests may be in conflict with that of the Board, which represents the majority shareholders' interests.²⁴

Authors have characterised this friction between the principal actors in a corporate entity as 'agency problems'.²⁵ When two parties interact with each other in a relationship whereby the welfare of one is contingent on the actions of the other, with the former being the principal and the latter the agent, a core problem ensues.²⁶ The same lies in ensuring that the agent does not act only in their self-interest in a manner that jeopardises the principal's welfare.²⁷ In a corporation, the agency problem typically manifests in three ways

¹⁶ Varottil, *supra* note 4, 284-286.

¹⁷ *Id.*, 284.

¹⁸ *Id.*, 285.

¹⁹ *Id.*

²⁰ *Id.*, 284, 285.

²¹ *Id.*, 286.

²² *Id.*

²³ *Id.*, 287.

²⁴ *Id.*

²⁵ Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, Vol. 161, UNIVERSITY OF PENNSYLVANIA L. REV., 2003 (2013) (This paper recognises the critiques levelled against the agency-costs construct. It only utilises this framework to provide a structure to understand the different nature of the conflicts corporate governance faces in varied jurisdictions).

²⁶ Kraakman, *supra* note 1, 29.

²⁷ *Id.*

— in the relationship between the managers (managers by virtue of their position as directors on the Board and executive managers) and shareholders, the majority shareholders and minority shareholders, and the corporate entity itself (including shareholders) and third parties with whom it engages with, including employees, consumers, and creditors.²⁸

Corporations following the outsider and insider shareholding models face different agency problems. The outsider model suffers from agency problems arising from the directors-shareholders conflict,²⁹ while the insider model suffers from agency problems ensuing from the majority-minority shareholder conflict.³⁰ The differences in the agency costs incurred in the two shareholding models problematise our understanding of the concerns that the institution of the independent director seeks to address in each model. The role of the independent director in confronting both kinds of agency costs, as identified by Kraakman and others, takes the form of a trusteeship strategy — an *ex-ante* mechanism wherein their motivation as agents to discharge their functions is delinked from considerations that can create conflicts of interest.³¹

In the trusteeship strategy, the *ex-ante* mechanism focuses on strategies to align the incentives of the agent to safeguard against their ability to incur benefits from acting against the principal.³² The role of an independent director as an agent in this strategy is designed to ensure that they are not involved in the day-to-day management decisions and are not remunerated solely based on the company's share performance.³³ Consequently, these independent directors will not benefit from actions that disproportionately favour the principals — the managers (outsider model) or majority shareholders (insider model).³⁴ Therefore, one can expect that financial imperatives do not constitute their primary motivation in discharging their role.³⁵ Instead, in this incentive structure, independent directors are Board members who act on ethical and reputational considerations,³⁶ much like a trustee.³⁷

B. THE EMERGENCE OF THE INSTITUTION OF THE INDEPENDENT DIRECTOR AS A RESPONSE

In the USA and the UK, the independent director emerged as a corporate board's practice to tackle the manager-shareholder agency problem.³⁸ Given this purpose, the role of the independent director in American and British legislation and precedent is well-defined to address this conflict. The independent director does not owe any duty to the minority shareholders' concerns, evidenced by the exceptions framed for controlled companies.³⁹

In India, although the insider shareholding model creates a majority-minority shareholder agency problem, the initial compliance provisions concerning the independent director for publicly listed companies did not envision the role to address the same. For

²⁸ *Id.*, 29, 30 (the order maintained in the description of each conflict is principal-agent).

²⁹ Varottil, *supra* note 4, 290.

³⁰ *Id.*

³¹ Kraakman, *supra* note 1, 35, 62.

³² *Id.*, 35.

³³ *Id.*, 62.

³⁴ *Id.*, 35.

³⁵ *Id.*, 62.

³⁶ Ronald W. Masulis & Shawn Mobbs, *Independent Director Incentives: Where do Talented Directors Spend their Limited Time and Energy?*, Vol. 111, J. OF FINANCIAL ECON., 406 (2014); David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, Vol. 54, J. OF FINANCE, 2281 (2004).

³⁷ Kraakman, *supra* note 1, 62.

³⁸ Varottil, *supra* note 4, 304.

³⁹ New York Stock Exchange Manual, §303A.00 (U.S.A.); NASDAQ Rules, §5615(c) (U.S.A.).

instance, Clause 49 mandated that one-third of the Board of publicly listed companies comprise independent directors but did not specify the interests the independent directors represented, nor did it envisage their role in addressing the minority shareholders' concerns.⁴⁰ This changed with the Companies Act in 2013, which similarly mandates at least one-third of the Board of publicly listed companies to consist of independent directors.⁴¹ The provisions of the Companies Act clearly identify the role that the independent director is meant to primarily play to safeguard the interests of a wide range of stakeholders, particularly minority shareholders and regulators.⁴² The introductory note to Schedule IV of the Companies Act, 2013, evidences the same.⁴³

III. THE ROLES, RESPONSIBILITIES, AND LIABILITY OF THE INDEPENDENT DIRECTOR

This Section is divided into two parts. Firstly, the 2013 Act's division between executive and non-executive directors is discussed, and the specific statutory provision, §149(12), affixing liability on the latter group, inclusive of the independent director, is analysed. Secondly, the 2013 Act's unclear delineation of the difference in the roles and responsibilities to be discharged by the two groups of directors in its remaining provisions is brought to the fore using §§166 (2) and (3), which govern the duties of directors generally, and Schedule IV of the Act governing independent directors specifically, illustrates this lack of clear differentiation.

A. §149(12) AND THE INDEPENDENT DIRECTOR'S LIABILITY

Prior to the enactment of the 2013 Act, the roles and responsibilities of company directors were generally understood through the concept of fiduciary duty based on common law principles.⁴⁴ Significantly, the 2013 Act introduced a distinction between executive and non-executive directors,⁴⁵ with the institution of independent directors as a subset of non-executive directors.⁴⁶

Typically, executive directors are involved in the daily operations and management of the company, while non-executive directors, including independent directors, do not have day-to-day oversight or control.⁴⁷ Accordingly, accounting for their absence from the daily affairs and management of the company, §149(12) of the 2013 Act carves out a separate threshold to hold the non-executive or independent director liable for the acts or omissions of the company and its mismanagement. §149(12) affixes liability on the independent or non-executive director for the company's actions or omissions which occurred within this knowledge, attributable through Board processes, and with their consent or connivance or where they did not act diligently.⁴⁸

A *prima facie* reading of the provision suggests that all three conditions, i.e., (i) acts of omission or commission that occurred with the independent director's knowledge, (ii) that are attributable through the Board process, and (iii) with their consent or connivance, or

⁴⁰ Varottil, *supra* note 4, 317.

⁴¹ The Companies Act, 2013, §49(4).

⁴² *Id.*, §149(8), Sch. IV.

⁴³ *Id.*

⁴⁴ Prasad, *supra* note 15, 11.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*, 12.

⁴⁸ The Companies Act, 2013, §149(12).

where they had not acted diligently, are conjunctive for an independent director to be held liable.

Alternatively, it has also been suggested by Prasad, Ansari & Narayan that the non-executive director (including the independent director) is liable “only if an act of commission or omission has been done with their knowledge; and/or attributable through board processes; and with their consent or connivance; or where he/she had not acted diligently”.⁴⁹

In both interpretations, the knowledge possessed by the independent director of the misconduct is the *sine qua non* in establishing their liability. It is only the source of knowledge that is debated. This knowledge must be attributable to the Board process in the *prima facie* reading of §149(12). On a deeper reading of §149(12), however, this knowledge need not be traced only to the Board process.

Regardless of which interpretation is adopted, the concept of knowledge encompasses both active and constructive knowledge. The latter refers to the knowledge that the independent director ‘ought’ to have possessed based on the circumstances taking place in the company. The same is the case since, irrespective of whether the knowledge requirement is strictly in relation to the board process or not, in both the interpretations of §149(12), it is imperative to assess the independent director’s diligence in discharging their duties in affixing liability or whether there was any consent or connivance on the independent director’s part in relation to the misconduct.

In the absence of consent or connivance, the diligence requirement necessitates the assessment of whether the independent director has applied their mind, discussed proposals at length, and obtained the required information from the board or other sources when needed.⁵⁰ Neither the mere absence of the independent director from the Board meeting(s) nor the knowledge gained during the Board process being insufficient discharges them from liability. Therefore, the actions of the independent director are also required to be assessed on the metric of diligence, i.e., beyond the test of knowledge attributable to the board process.

It is pertinent to note that despite this distinction between executive and non-executive directors (being inclusive of independent directors), apart from §149(12), the remaining statutory provisions in the 2013 Act do not clearly delineate the difference in the roles and responsibilities to be discharged by the two groups of directors.⁵¹ A reading of §§166 (2) and (3) of the 2013 Act in the next part of this Section, which governs the duties of directors generally and Schedule IV of the Act governing independent directors specifically, illustrates this lack of clear differentiation.

B. LACK OF CLARITY IN THE 2013 ACT REGARDING THE INDEPENDENT DIRECTOR’S ROLES AND RESPONSIBILITIES

§166(2) requires the director of a company to “act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment”.⁵² Additionally, §166(3) mandates that directors discharge their duties

⁴⁹ Prasad, *supra* note 15, 12.

⁵⁰ Shuai Qin et al., *Does the Attendance of Independent Directors at Shareholder Meetings Matter? The Case of Risk Taking*, Vol. 11(4), CHINA J. OF ACCOUNTING STUDIES, 3 (2023).

⁵¹ Prasad, *supra* note 15, 13.

⁵² The Companies Act, 2013, §166(2).

with “due and reasonable care, skill and diligence” and “exercise independent judgement”.⁵³ Simultaneously, Schedule IV of the Act requires independent directors, who are non-executive directors, to account for the “investment community, particularly minority shareholders, regulators and companies in the institution of independent directors” in their professional conduct.⁵⁴

If every director appointed is required to exercise independent judgement and account for the interests of multiple stakeholders, the particular role of the independent director, who is not involved in the daily affairs of the company, is brought into question. Schedule IV does not provide any clarity on this question. In fact, the 2021 Supreme Court decision in *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.* labelled the simultaneous existence of the two provisions a ‘paradox’, with the expansive roles and responsibilities of any director under §§166(2) and (3) rendering the need for an independent director having to discharge similar functions infructuous to that extent.⁵⁵

In particular, the three-judge bench reasoned that expecting every director of the company to act in good faith and simultaneously keep in mind the interests of shareholders, stakeholders, and the environment as required by §§166(2) and (3) would render the appointment of a separate independent director futile.⁵⁶ The Court went even further and highlighted that mandating every public company to have at least one-third of the Board positions occupied by independent directors served little purpose if every director, as per §166(3), was anyway required to exercise their independent judgement.⁵⁷ Noting this ‘paradox’, the Court left the matter undecided and concluded the discussion with a rhetorical question, and asked, “whether the prescription in §149(4) is a tacit acknowledgement that all the Directors appointed in a General meeting under §152(2) may not be independent in practice, though they may be required to be so in theory”.⁵⁸

Other authors have also underscored a similar lack of clarity in the independent director’s role and responsibilities in the 2013 Act. Khanna & Varottil highlight practical concerns that may arise in the independent director’s discharge of their duties.⁵⁹ Independent directors may confront situations wherein the interests of other stakeholders, for instance, the employees or customers, conflict with those of the shareholders.⁶⁰ They are required to prioritise interests in a hierarchical fashion in such situations, thereby operating with considerable unobstructed discretion.⁶¹ Additionally, it may be easier for independent directors to account for the interests of shareholders, which are premised on tangible and measurable metrics, including identifiable financial parameters such as the share price and other indicators of corporate governance performance.⁶² The same may not be the case with regard to stakeholder interests that are often premised on more intangible and subjective metrics, such as employee or customer satisfaction.⁶³ Once again, this leaves the incorporation of stakeholder concerns into decision-making to the considerable discretion of the independent directors.⁶⁴

⁵³ *Id.*, §166(3)

⁵⁴ *Id.*, §149(8), Sch. IV.

⁵⁵ *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.*, (2021) SCC OnLine SC 272, ¶217.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Khanna & Varottil, *supra* note 15, 26 (These concerns are common not only to the independent director, but all non-executive and executive directors on the Board, whose duties are similarly expansive under the 2013 Act).

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*, 26, 27.

⁶⁴ *Id.*

Moreover, the authors also note that while such concerns may be addressed through Board deliberation processes devised to account for them,⁶⁵ more fundamentally, the Act does not envisage remedies to be resorted to in situations where stakeholder concerns and interests are not considered by the Board.⁶⁶ Khanna & Varottil's concerns are relevant today as well, with the independent director's roles and responsibilities remaining open-ended in the absence of any amendments or accompanying rules addressing the same.

Given this delineation of the legislative architecture of the roles and responsibilities of the independent director as per the 2013 Act, it is imperative to understand how they have been judicially interpreted. To examine the above, this paper analyses SEBI and SAT's interpretation of §149(12), which affixes liability on the independent director for the acts or omissions of the company and its mismanagement.⁶⁷

IV. THE JUDICIAL INTERPRETATION OF §149(12)

Based on a reading of recent cases pertaining to the interpretation of §149(12) decided by SEBI and SAT, this paper observes two lines of reasoning employed by the adjudicating bodies in such cases.

A. THE DAY-TO-DAY FUNCTIONING TEST AND IGNORING THE DILIGENCE REQUIREMENT

This paper will first consider the day-to-day functioning test. In practice, this test has seen a few trends. Firstly, the adjudicating bodies assess the conduct of the independent director(s) on the basis of their participation in the daily affairs of the company in which the misconduct has occurred, which this paper identifies as the 'day-to-day functioning' test. Secondly, these authorities often conclude that the knowledge gained by the independent director during the Board's processes was insufficient to raise suspicion. Finally, whether there was diligence, consent, or connivance on the independent directors is ignored, although the same is necessitated by either of the two interpretations of the provision, as explained in the previous Section.

The following cases are illustrative of the misplaced use of the day-to-day functioning test and the ignorance of the diligence test. In *MPS Infotechnics Ltd. v. SEBI* ('MPS Infotechnics'), the company's Board resolution had authorised the issuance of shares underlying the Global Depository Receipts ('GDRs') without adequate disclosure, in violation of SEBI's Listing Agreement.⁶⁸ The Board resolution, in which the independent director participated, authorised a credit scheme with a foreign bank to subscribe to the GDRs.⁶⁹ This was not disclosed by the company and was misrepresented to investors as a genuine subscription to the GDRs.⁷⁰ Here, SEBI held that although the independent director was a member of the Board resolution that was instrumental to the company's subsequent non-disclosure, he was discharged from his liability.⁷¹ No liability was imposed on the premise that

⁶⁵ *Id.*, 27.

⁶⁶ *Id.*

⁶⁷ §149(12) is chosen since a decision on affixing liability on the independent director is preceded by a discussion on what roles and responsibilities they were required to discharge and failed to do so.

⁶⁸ *MPS Infotechnics Ltd. v. Securities and Exchange Board of India*, SEBI GR/RR/2020-21/10111 (Securities and Exchange Board of India), ¶¶1, 5(c) (Unreported).

⁶⁹ *Id.*, ¶11(f).

⁷⁰ *Id.*, ¶¶5(b)-(c).

⁷¹ *Id.*, ¶11(j).

he did not glean any knowledge concerning any fraudulent act by being a part of the Board process and was not a part of the company's day-to-day management.⁷²

Similarly, in *Svam Software Ltd. v. SEBI* ('Svam Software'), the company's non-disclosure of related party transactions and loans was adjudicated upon.⁷³ These loans were mentioned in the annual report, which was discussed by the audit committee.⁷⁴ The audit committee is a significant component of the Board process. Despite this, by entirely relying on the 'day-to-day' functioning test, the independent director, who was part of the audit committee where these disclosures were made but not followed through with regard to SEBI, was not held liable.⁷⁵

In fact, the employment of the 'day-to-day' functioning test has even transcended the §149(12) context and seems to be ubiquitous with any assessment of an independent director's actions and liability under other governing laws. For instance, in *the Matter of Karvi Stock Broking* ('Karvi Stock Broking'), the relevant entity was a public company dealing in portfolio management, which failed to fulfil its obligations under SEBI's Portfolio Management Regulations.⁷⁶ The violations dealt with failure to appoint an appropriate and qualified Principal Officer, a lack of uniformity regarding termination of agreements with clients, and the existence of contrary provisions relating to placement fees in disclosure documents, amongst others.⁷⁷ In their submissions, the independent directors argued that no details regarding any of the violations were given to them during Board meetings.⁷⁸ Further, they argued that even otherwise, they were not involved in the day-to-day operations.⁷⁹ Relying on this argument, SEBI, in its analysis of the liability of the independent directors, held that there was no material to show that the independent directors were involved in the day-to-day affairs of the company, and hence they were not liable.⁸⁰

By employing the day-to-day functioning test, linking the knowledge requirement strictly to information gained during the Board process, and not checking for diligence, this paper argues that the adjudicative bodies have envisaged the role of the independent director as analogous to, and at times, even the same as that of other Board members. The same necessitates a check on their involvement in the day-to-day management of the company, in the absence of which they are not held liable. Their participation in the Board processes where the actions or omissions of the company are in question and their lack of action regarding the same are rendered entirely irrelevant. This translates into a significantly low threshold not to hold the independent director liable, especially considering that daily participation in the company's affairs as non-executive directors, anyway, lies outside the ambit of the independent director's role.⁸¹ The implications of the same are discussed in greater detail in Section V.

⁷² *Id.*, ¶11(j).

⁷³ *Svam Software Ltd. v. Securities and Exchange Board of India*, SAT Mumbai Appeal No. 801/2021 (Securities Appellate Tribunal), ¶20 (Unreported).

⁷⁴ *Id.*, ¶18.

⁷⁵ *Id.*, ¶26.

⁷⁶ *In the matter of Karvi Stock Broking Limited and Another*, (2022) SCC OnLine SEBI 1658, Securities and Exchange Board of India, ¶1.

⁷⁷ *Id.*, ¶2.

⁷⁸ *Id.*, ¶¶30-32.

⁷⁹ *Id.*

⁸⁰ *Id.*, ¶37.

⁸¹ Prasad, *supra* note 15, 11-12.

B. ACCOUNTING FOR THE INDEPENDENT DIRECTOR'S UNIQUE ROLE AND CHECKING FOR DILIGENCE

Simultaneously, in employing the second line of reasoning, certain cases do recognise the independent director's particular role (vis-à-vis other directors) of maintaining checks and balances and independently reviewing Board activities and accounting for the diligence requirement as per §149(12). Two decisions that best exemplify this reasoning are *Dish TV India Ltd v. SEBI* ('Dish TV') and the *SEBI matter of Bombay Dyeing and Manufacturing Company Ltd* ('Bombay Dyeing').

In *Dish TV*, the case pertained to the non-disclosure of the Annual General Meeting's ('AGM') voting results as per SEBI requirements, with the independent directors being made a party.⁸² The independent directors involved argued that although they participated in the Board processes, the decision not to disclose the AGM results was not discussed and that there existed no consent or connivance on their part.⁸³ However, the SEBI order expanded its scope of analysis, acknowledging that independent directors might acquire knowledge outside of the Board process and are expected to act diligently based on that knowledge.⁸⁴ Ultimately, the independent directors were not held liable in this case.⁸⁵ However, what is important is SEBI's extended understanding of an independent director's duties.

Further, in the *Bombay Dyeing* case, the company had inflated its sales and profits by misrepresenting as revenue transactions concerning the purchase of building/flat units between itself, *Bombay Dyeing and Manufacturing Company Ltd* ('BDMCL'), and *SCAL Services Ltd* ('SCAL'), without there being any actual sale.⁸⁶ SCAL did not record these transactions as purchases in its accounts but only noted resultant profit/loss.⁸⁷ Here, the independent directors involved were members of the audit committee.⁸⁸ While there were various indicators that hinted towards plausible misconduct and mismanagement, the independent directors failed in their duty to exercise oversight over BDMCL's financial reporting process.⁸⁹ For instance, SCAL had a negative net worth,⁹⁰ and had even taken a loan from an insolvent entity to pay BDMCL for these transactions. The comfort letter came from BDMCL,⁹¹ which also reduced its shareholding in SCAL from forty-nine percent to nineteen percent only a day before entering into Memoranda of Understanding with SCAL for these transactions.⁹²

SEBI reasoned that the independent directors had failed to exercise due diligence even when multiple transactions and observations made it clear that there were

⁸² *Dish TV India Ltd. v. Securities and Exchange Board of India*, SEBI WTM/AB/CFD/CMD-1/17895/2022-23 (Securities and Exchange Board of India), ¶1(viii) (Unreported).

⁸³ *Id.*, ¶19.

⁸⁴ *Id.*, ¶30.

⁸⁵ *Id.*, ¶31.

⁸⁶ *In the matter of Bombay Dyeing and Manufacturing Company Limited*, Adjudication Order/AA/ RK/ 2022-23/20965-20973 (Securities and Exchange Board of India), ¶1 (Unreported) ('In the matter of Bombay Dyeing and Manufacturing Company Limited, Adjudication Order').

⁸⁷ *In the matter of Bombay Dyeing and Manufacturing Company Limited*, Final Order WTM/AB/CFID/CFID_1/20686/2022-23 (Securities and Exchange Board of India), ¶20 (Unreported).

⁸⁸ *In the matter of Bombay Dyeing and Manufacturing Company Limited*, Adjudication Order, *supra* note 86, ¶6.
⁸⁹ *Id.*, ¶85.

⁹⁰ *Id.*, ¶36.

⁹¹ *Id.*, ¶37.

⁹² *Id.*, ¶74.

irregularities in the financial statements.⁹³ They had failed to seek explanations for BDMCL entering into transactions with SCAL when serious and noticeable concerns existed regarding the latter's ability to pay BDMCL. SEBI held that the independent directors should not have completely relied on the opinion of the company's chartered accountant without ensuring due diligence on their part.⁹⁴ The independent directors were ultimately held liable.⁹⁵

Evidently, the aforementioned cases use the due diligence requirement to explain the liability of independent directors. If the reasoning in Dish TV and Bombay Dyeing had been applied in MPS Infotechnics and Svam Software, the independent directors would have been liable for the lack of diligence shown. In MPS Infotechnics, the liability would be affixed for not obtaining further information, especially in light of the communication to investors on the issue of GDRs by way of a credit scheme in the Board resolution. In Svam Software, the liability would be affixed for not investigating the discrepancy in the disclosure of loans advanced in the audit committee board procedure and SEBI disclosure information.

Therefore, the two different types of decisions only contribute to muddling the landscape of the role of the independent director and cast aspersions as to duties and the interests that they are required to protect as defined in the 2013 Act. While one interpretation of §149(12) envisages the independent director to discharge the same role as other Board members, thereby only applying the day-to-day functioning test in determining their liability, the second interpretation recognises the independent director's particular role (unlike other directors) of maintaining checks and balances and independently reviewing Board activities, and account for the diligence requirement as per §149(12).

V. THE CONSEQUENCES OF (MIS)USING THE DAY-TO-DAY FUNCTIONING TEST AND IGNORING §149(12)'S DILIGENCE REQUIREMENT

Having outlined the two different lines of reasoning employed by SEBI and SAT to assess the independent director's liability as per §149(12), the manner in which the use of the former, the day-to-day functioning test, muddles the landscape regarding the role of the independent director is highlighted.

The discussion in this Section will focus on the pitfalls of employing the day-to-day functioning test. Subsequently, this paper argues with reasons for adopting a thorough analysis of the diligence requirement as, in fact, necessitated by §149(12), similar to the reasoning employed in Dish TV and Bombay Dyeing.

A. FALLACIES IN MPS INFOTECHNICS AND SVAM SOFTWARE'S INTERPRETATION OF §149(12)

First, the first set of cases incorrectly employs the day-to-day functioning test in assessing the liability of the independent directors. The problem lies in the assumption that independent directors are required to perform such day-to-day functioning. As highlighted in Section III.A., while otherwise lacking clarity, the 2013 Act's distinction between executive and non-executive directors is premised on the latter's non-participation in the company's daily affairs.⁹⁶ Independent directors, being a part of the class of non-executive directors by the

⁹³ *Id.*, ¶77.

⁹⁴ *Id.*, ¶75.

⁹⁵ *Id.*, ¶85.

⁹⁶ Prasad, *supra* note 15, 11.

nature of their designation, are not required to be involved in the company's day-to-day functioning.⁹⁷ The threshold of day-to-day functioning is a misapplication of the 2013 Act.

Second, MPS Infotechnics and Svam Software ignore the diligence requirement necessitated by the two prevailing opinions on §149(12)'s interpretation, as outlined in Section III.B. The interpretation of §149(12) is limited to whether the knowledge gained through the Board process was sufficient to raise suspicion. By affixing liability primarily on the basis of Board participation or the lack thereof, the adjudicating bodies have entirely ignored the element of lack of due diligence (or even consent or connivance). Once again, there is little deference paid to the text of §149(12). Consequently, there is no incentive for independent directors to exercise any diligence regarding the information gleaned through Board participation.

Third, affixing liability in this manner does not allow for the accomplishment of the independent director's role, even to the extent specified in the 2013 Act. The Act requires that the independent director particularly advocate for the interests of the minority shareholders and regulators.⁹⁸ As per Schedule IV and other provisions of the Act, their role includes bringing an objective view in the evaluation of the company's performance and satisfying themselves on the integrity of the financial information among the other functions.⁹⁹

In fact, Khanna identifies the role of the independent directors as strategic advisors and watchful monitors who prevent the company from entering into any legal or financial trouble.¹⁰⁰ To fulfil this role, they have to attend board meetings and participate in various committees like the Audit Committee,¹⁰¹ and Nomination and Remuneration Committee.¹⁰² Therefore, given that the independent directors already do not participate in the daily management of the company,¹⁰³ it is imperative that they advocate for these stakeholders during the Board process. The Board processes (meetings and resolutions) offer the only avenue for Board discussions to account for stakeholder perspectives apart from that of the majority shareholders in the Indian context, whose interests are prioritised by the rest of the Board.

B. SUBSTANTIATING THE NEED FOR THE DILIGENCE TEST TO ASSESS THE INDEPENDENT DIRECTOR'S LIABILITY

This paper recognises that various authors have argued that the 2013 Act's liability regime is a burden and incommensurate with the duties of independent directors.¹⁰⁴ They argue that this has contributed to the resignation spree amongst independent directors.¹⁰⁵ Further, the online business environment after COVID-19 has rekindled the fear of corporate misgovernance amongst independent directors due to increased fraudulent activities.¹⁰⁶ Pointing to the same, they argue that independent directors are reluctant to join companies. It

⁹⁷ *Id.*, 12.

⁹⁸ The Companies Act, 2013, §149(8), Sch. IV.

⁹⁹ *Id.*, Sch. IV.

¹⁰⁰ Vikramaditya Khanna & Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer*, Vol. 22(1), NATIONAL L. SCHOOL OF INDIA REV., 37 (2010).

¹⁰¹ The Companies Act, 2013, §177.

¹⁰² *Id.*, §178.

¹⁰³ *Id.*, §§2(47), 149(6).

¹⁰⁴ Vidhi, *supra* note 9, 29.

¹⁰⁵ *Id.*, 33.

¹⁰⁶ DELOITTE, *Corporate Fraud and Misconduct: Role of Independent Directors*, 11 (October, 2021), available at <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/finance/in-fa-Corporate-fraud-and-misconduct-noexp.pdf> (Last visited on August 6, 2024).

is argued that a more thorough analysis of the independent director's diligence does not unduly disadvantage them for the following reasons.

First, multiple safeguards exist for independent directors as long as they discharge their duties responsibly. Independent directors (and other Board directors) may obtain directors' insurance from the company as implicitly recognised by the 2013 Act except in cases of fraudulent action or wilful or intentional misconduct.¹⁰⁷ Moreover, the Ministry of Corporate Affairs has also clarified the liability of the independent director in its recent circular.¹⁰⁸ The circular states that criminal and civil proceedings cannot be initiated against independent directors till there is evidence existing to the contrary.¹⁰⁹ The burden of proof is on the other party to show that there has been a failure of the independent director to fulfil their duty.

Second, the diligence requirement does not place an undue burden on independent directors. Ordinarily, this would entail that if an independent director could not gain the necessary information to prevent the company's misconduct, they would need to seek that information through alternative means. The independent director is appointed by virtue of their professional qualifications and standing from a pool of well-qualified candidates.¹¹⁰ Often, independent directors come from professional backgrounds in finance, law, management, and corporate governance.¹¹¹ When any suspicious activity is gleaned through their participation in the Board process, though they do not participate in the company's daily affairs or even if relevant information is hidden from them, such well-qualified independent directors can ascertain information concerning the company outside the Board process. Moreover, §149(12) already mandates a diligence check; it is only some judicial decisions which have ignored the same.

In fact, the emphasis on the need to test the independent director's actions carried out in connection with the company's misconduct against the diligence metric, in addition to examining their knowledge gained through the Board process of this misconduct, aligns with the recent regulatory developments. SEBI recognised that independent directors may not be incentivised to act on behalf of the stakeholders identified in the Act since their appointment after being selected by the Board was premised on an ordinary resolution passed by shareholders, with a simple majority.¹¹² This would entail the independent director being elected by the promoter families, who hold the majority of shares in the Indian context, thereby ignoring the representational interests of minority shareholders. Only their re-appointment required a three-fourths majority to be ratified by shareholders by a special resolution.¹¹³ Recently, with effect from 1 January 2022, all listed public entities are required to appoint, re-appoint, and remove independent directors by means of a special resolution,¹¹⁴ — thereby ensuring that minority shareholders exercise power in the independent director's appointment

¹⁰⁷ Khanna & Varottil, *supra* note 15, 9.

¹⁰⁸ Securities and Exchange Board of India, General Circular No. 01/2020 (Issued on March 2, 2020).

¹⁰⁹ *Id.*

¹¹⁰ The Companies Act, 2013, §150.

¹¹¹ The Companies (Appointment and Qualification of Directors) Rules 2014, R. 5.

¹¹² Securities and Exchange Board of India, Consultation Paper on Review of Regulatory Provisions Related to Independent Directors (Issued on March 1, 2021).

¹¹³ *Id.*

¹¹⁴ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirement) Regulations 2015, Reg. 25(2A); THE ECONOMIC TIMES, *SEBI Amends Rules; Introduces New Option for Appointment, Removal of Independent Directors*, November 15, 2022, available at <https://economictimes.indiatimes.com/markets/stocks/news/sebi-amends-rules-introduces-new-option-for-appointment-removal-of-independent-directors/articleshow/95532407.cms?from=mdr> (Last visited on March 5, 2024).

in the absence of the simple majority voting procedure. Moreover, if such a resolution did not attain the three-fourths majority, especially in the case of appointment or removal of the independent director, two alternate mechanisms, that of an ordinary resolution with a simple majority, or the majority of the minority threshold, may be utilised.¹¹⁵

These new amendments indicate a definite shift in protecting the rights of minority shareholders in the context of the independent director's role. Indian law, therefore, has adapted, in Kraakman and others' words, the trusteeship strategy¹¹⁶ to ensure that the incentives for the independent directors to discharge their functions responsibly are de-linked from any ties to the majority shareholders in the appointment process. Therefore, this *ex-ante* mechanism minimises the majority-minority shareholder agency problem in the Indian context, where insiders form the majority group of shareholders in Indian companies, with the remaining shares owned diffusely by a minority. The judicial interpretation of the roles and responsibilities of independent directors should be aligned with what was envisaged by the legislature.

VI. CONCLUSION

Through this paper, the authors have elaborated upon the continuing ambiguity in the role of the independent director vis-à-vis other Board directors. Existing literature in this regard focuses solely on the lack of legislative clarity on the roles and responsibilities of independent directors, especially when compared to other directors on the Board. This piece makes a novel intervention by arguing that in a series of cases, SEBI and SAT findings regarding the liability of independent directors belonging to the non-executive director class are premised on the incorrect assumption that they are required to contribute to the daily working of the company and employ the 'day-to-day' functioning test.

The 2013 Act clearly distinguishes the roles and responsibilities of executive and non-executive directors, where only the former group is required to participate in the daily affairs of the company. Adjudicative bodies have failed to appreciate this difference and conduct checks only on the independent director's involvement in the day-to-day management of the company, in the absence of which they are not held liable. Their participation in the Board processes where the company's misconduct is in question and their lack of action regarding the same are rendered entirely irrelevant. This translates into a significantly low threshold, not to hold the independent director liable, especially considering that daily participation in the company's affairs as a non-executive director anyway lies outside the ambit of the independent director's role.

Further, the article highlighted the incongruous nature of this reasoning with the possible interpretations of the independent director liability provision, §149(12) in the 2013 Act, which requires that the independent director's actions be tested against the diligence metric (in addition to examining their knowledge gained through the Board process of this misconduct). The reasoning also does not align with the recent regulatory developments issued by SEBI, which are in favour of assessing the independent director's actions against the diligence metric. Additionally, a thorough analysis of the independent director's diligence does not unduly burden the independent director, and multiple safeguards exist. Therefore, for the

¹¹⁵ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2022.

¹¹⁶ Kraakman, *supra* note 1, 35, 62.

reasons stated above, it is advisable for SEBI and SAT to move away from employing the day-to-day functioning test in assessing the independent director's liability.

Thus, to conclude, this paper argued that the divergent SEBI and SAT jurisprudence concerning §149(12) further muddles the unclear landscape of the roles and responsibilities of independent directors vis-à-vis other Board directors.